

Global Insight

Weekly

When the Fed goes low, we go high

Thomas Garretson, CFA – Minneapolis

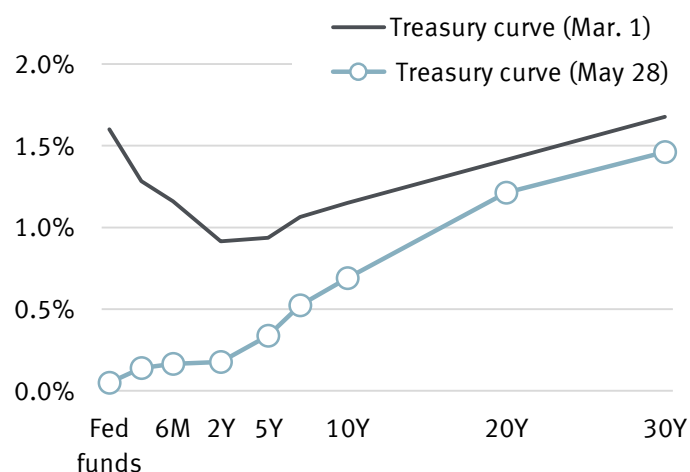
The Fed is dusting off an obscure policy tool—yield curve control—as it ramps up efforts to keep Treasury yields low. So, we look to go where yields remain high—that is, high-yield corporates—and explore our shift to a positive outlook on the sector.

Though U.S. interest rates are at zero percent, and Treasury yields are near record lows, the Fed is apparently looking for more ways to ensure that remains the case, and for longer. This week, New York Fed President John Williams grabbed headlines by confirming that the next policy tool under consideration may be yield curve control. Speaking with Bloomberg, Williams said, “Yield curve control, which has now been used in a few other countries, is I think a tool that can complement—potentially complement—forward guidance and our other policy actions. So this is something that obviously we’re thinking very hard about.”

The basic structure of a yield curve control program is that the Fed would target a specified yield target at certain points on the Treasury yield curve—pledging to buy, or sell, as many Treasuries as necessary—to peg yields to a certain level. The other countries he is referencing are Japan, which is targeting a 10-year yield of zero percent, and more recently Australia, which as of March is targeting a 3-year government bond yield of around 0.25 percent.

The Fed has actually used yield curve control in the past, specifically during World War II, in an effort to keep government financing costs for the war effort low, as the Fed capped long-term Treasury yields around 2.5 percent. But looking to where the Fed finds itself today, in some ways the strategy might actually be preferable to the Fed’s currently unlimited quantitative easing program.

How might the Fed want to remake the yield curve?



Source - RBC Wealth Management, Bloomberg

Market pulse

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Wealth
Management

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The price of success

Under quantitative easing, central banks simply buy securities in bulk, hoping to push around markets—and yields—to achieve a largely undefined goal. Under yield curve control, central banks only need to buy as needed to achieve the stated objectives—when the yield curve targets were announced in 1942, the Fed did not actually buy in large quantities in the years that followed, but was still able to keep yields in check. And with the Fed's balance sheet now beyond \$7 trillion, the Fed may be looking for a more cost-effective approach to stimulating the economy via low borrowing rates.

To be sure, Williams went on to say that the tool may have little impact at the moment given the low state of yields. As the chart on page 1 shows, the yield curve is already essentially flat through 2-year maturities as the market expects an extended period of zero percent Fed policy. For now, forward guidance will likely remain the Fed's primary tool, but a yield curve control program could be used to reduce yields, likely around the 5-year maturity to start, in our view, should the Fed go down that path.

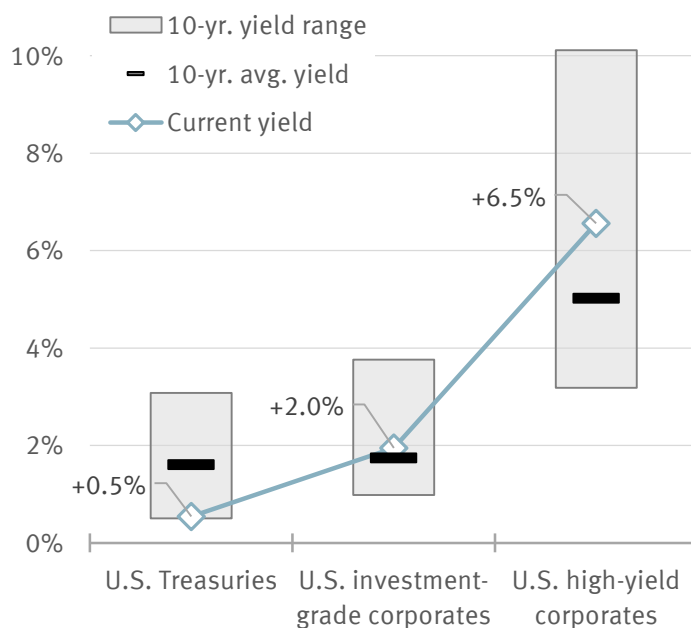
Upgrading the outlook for U.S. high-yield corporate bonds

So with the Fed ramping up efforts to keep yields low, we look to go where yields remain high. For credit investors, the key metric to assess valuations is the yield compensation over risk-free Treasuries. On that basis we continue to see historically attractive levels in U.S. high-yield corporates, and now shift to a positive outlook on the sector, having turned Neutral in mid-March at the peak of the market selloff.

As the chart on the right shows, the average yield on an index of Treasury securities is at a record-low yield of just 0.50 percent. Investors can move to U.S. investment-grade corporates for an additional two percent yield over Treasuries, and though this yield advantage is about equal to the 10-year average, the 2.5 percent all-in yield at this stage isn't far-removed from the record low of just 2.2 percent. High-yield corporates, on the other hand, now yield 6.5 percent over Treasuries, well above the 10-year average of about five percent, for an all-in index yield of nearly seven percent, which is also above-average for the past decade.

Of course, risks remain on the horizon, particularly as year-to-date U.S. corporate bankruptcies have swelled to nearly 100 based on Bloomberg data, the fastest pace since the height of the global financial crisis. However, we still see an attractive risk-reward profile based partly on the back of ongoing monetary and fiscal stimulus support, and with companies able to shore up liquidity profiles by raising debt in capital markets that remain open for business. The number of companies with bonds trading at distressed levels—10 percent

U.S. high-yield corporate bonds still trade at above-average yields



Source - RBC Wealth Management, Bloomberg; shows IG and HY index yield advantage over Treasury index yield

over Treasuries—has declined by nearly half since March, with 463 now trading at heightened risk levels.

From a portfolio perspective, RBC Wealth Management's asset allocation guidelines would suggest that a classic 60 percent equity and 40 percent fixed income portfolio would contain a three percent Neutral allocation to high-yield corporates; our new Overweight recommendation would suggest a five percent allocation. But as is the case with any risk-oriented investments, diversification remains key, in our view, particularly with the depth and duration of the pandemic still highly uncertain.

The mantra playbook

In some way, this may be exactly what the Fed wants investors to do, and clearly echoes the "reach for yield" environment that swept markets during the zero interest rate policy regime in the aftermath of the 2008 global financial crisis. But in December 2009, when high-yield corporate bond valuations were similar to today's environment, the sector went on to deliver a total return of more than 15 percent over the next year, outpacing even stocks, which were up just over 11 percent, as the economic recovery took hold—a scenario we continue to expect in the back half of 2020. And so with the Fed dusting off the playbook of old, perhaps the old mantra of "don't fight the Fed" once again applies as well.



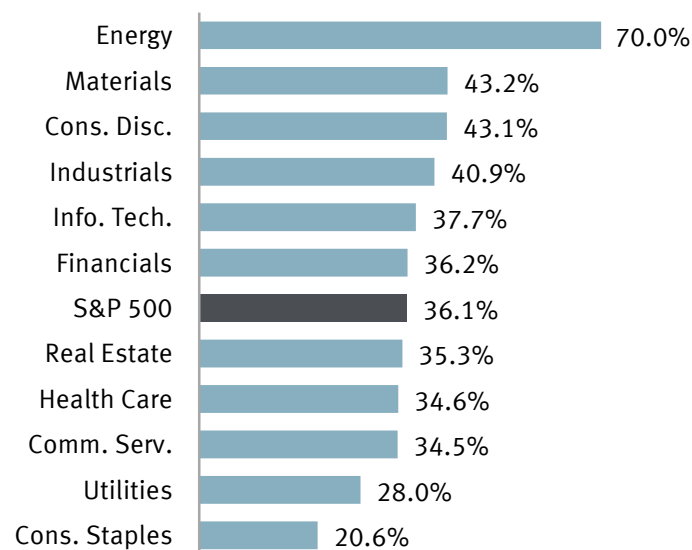
United States

Ben Graham, CFA – Minneapolis

- **U.S. equity markets have been broadly higher thus far this week, with a sharp change of leadership from growth to value stocks.** The value-oriented Dow Jones Industrial Average and Russell 2000 have outperformed the growth-oriented NASDAQ by nearly three and four percentage points, respectively, in recent days. **Powering the shift to value are the Financials and Industrials sectors**, with near-double-digit gains so far this week. These sectors have rallied 36% and 41%, respectively, from their March lows. Other leading sectors in the rebound include Consumer Discretionary, Energy, and REITs in Real Estate. The primary laggards are the defensively oriented Consumer Staples and Utilities, which provided downside protection through the selloff.
- **Consensus S&P 500 2020 earnings expectations appear to have stabilized around \$128** at the close of the Q1 earnings season. After falling rapidly in March and April, May saw earnings expectations prove reasonably resilient through the heart of earnings season. With 2020 earnings estimates **down 28% from their \$178 level at the beginning of the year** and further deterioration still possible, it's important to highlight our belief that the worst of the declines do appear to be in the rear view mirror. This belief is rooted in our view that the sharp decline was a result of expectations adjusting at an unprecedented pace to a pandemic-driven

Cyclically oriented sectors have led in the rebound

Performance since S&P 500 low on Mar. 23



Source - RBC Wealth Management, FactSet; data through 5/27/20

recession. Further downside in earnings, and as a result in the equity market, are possible; however, we believe **future adjustments should prove milder than the initial shock** given the deterioration that has already occurred and the incremental improvement (albeit from a low base) underway in the economy.

- **Unemployment remains sharply elevated** with new weekly claims totaling 2.1 million on May 28, approximately 10 times the pre-COVID-19 level. However, the small silver lining is that this week's new claims filings were 300,000 less than last week and **the overall number of workers receiving jobless benefits actually fell by 3.9 million, to 21.1 million.** This is still far larger than the previous peak of 6.5 million seen in 2009. Finally, markets are having difficulty gauging the potential impact of unemployment trends in the future given the unprecedented nature of the recent spike and uncertain path forward. Going forward, we believe **the pace of declines, rather than painful absolute unemployment levels, will be paramount in determining market outcomes.**



Canada

Arete Zafiriou & Meika McKelvey – Toronto

- **Canada's "Big Six" banks reported Q2 2020 earnings results this week. Provisions for credit losses (PCLs),** which reflect the amount banks set aside to cover potential losses due to underperforming loans, **increased substantially**, reflecting the impact of the COVID-19 pandemic and ongoing pressure on oil prices. Reported common equity Tier 1 (CET 1) ratios—a measure of a bank's capital—were flat-to-lower across the board but remained above levels where equity issuance becomes a pressing near-term concern. Adjusted earnings per share (EPS) for the quarter ending Apr. 30 decreased between 40% and 71% from the prior quarter. As expected by the Street, **all six banks maintained their dividends**, resulting in a number of dividend payout ratios upwards of 100% due to the decline in earnings. In our opinion, dividends are sustainable under a range of downside scenarios, in part due to our assumption that the banks are more likely to issue equity in the event capital is challenged to the degree that they would need to contemplate a reduced payout. **Canadian bank stocks bounced this week amidst the earnings reports but continue to lag the broader market** in 2020. Year to date ending May 28, the S&P/TSX Composite Index is down 9%, while the S&P/TSX Canadian bank sub-index is down 16%.
- **Bank of Canada (BoC) Governor Stephen Poloz made his final appearances this week** prior to his retirement on

Jun. 2, including one solo speech at the University of Alberta and an address to the Senate Committee on National Finance where he was accompanied by Senior Deputy Governor Carolyn Wilkins. Poloz stuck to his more upbeat belief that **the economy may be tracking closer to the BoC's more favourable scenario** from the April Monetary Policy Report, which sees the economy just a touch below Q4 2019 GDP levels by the end of this year. In terms of monetary policy, he maintained the stance that the overnight rate is currently sitting at the effective lower bound (0.25%)—pushing back on the prospects for negative rates—but reiterated the BoC's **willingness to do more if needed**. June 3 is Tiff Macklem's first rate meeting as BoC governor, where the market's expectation is for no significant policy changes.



Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The EU Commission proposed a plan for a €750 billion (or more than 6% of EU GDP) recovery fund** to facilitate a recovery in its hardest-hit regions and sectors. The proposal builds on the recent Franco-German proposal that called for €500 billion to be given out in grants and includes a further €250 billion to be paid out as loans. This fund would **boost the seven-year 2021–2027 EU budget**. This joint response is in addition to the significant stimulus national governments gave to their economies early in the crisis and to the substantial monetary stimulus of the European Central Bank.
- **The EU Commission aims to issue bonds that would be repaid in the long term** thanks to the revenues from new taxes and levies targeting carbon emissions, single-use plastics, and digital firms.
- That **the three most senior European politicians** have a uniform approach to economic relief suggests to us they **have grasped the severity of the situation and the need for an EU joint response**. Moreover, the proposal is a step towards risk sharing and a greater fiscal union. Should it be adopted, it would be supportive of European risk assets, and spread-widening in the periphery would likely be less intense.
- **But the proposal is very much a starting point**. More discussions, including how to tie grants to requests for economic reforms, are scheduled to take place at an EU summit in mid-June. In the end, we would expect a watered-down version of the proposal to be adopted in the second half of the year.



Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- The Asia-Pacific equity market traded mostly higher during the week, led by Japan and Australia. **The Japanese government lifted the country's state of emergency** as new cases of COVID-19 continue to decline. Economists have begun to adjust their very weak Q2 GDP growth forecasts for Japan slightly upwards. Prime Minister Shinzo Abe's cabinet approved a ¥117 trillion (US\$1.1 trillion) relief package to support the economy. The new measures will bring Japan's total stimulus spending to ¥234 trillion (US\$2.2 trillion), approximately 40% of GDP.
- **Australia's Treasury now expects the JobKeeper wage subsidy program to cost AUD\$70 billion, down from its initial estimate of AUD\$130 billion**. The Treasury forecasts fewer Australians to access the subsidy, in part because the "level and impact of health restrictions" were not as severe or long-lasting as anticipated. Meanwhile, the latest credit card spending data from Australia and New Zealand Banking Group and Commonwealth Bank of Australia suggests that retail spending is beginning to improve. The data boosted the "Big Four" Australian banks, which have led the rally in Australia's stock market.
- **Highlights from China's 2020 Government Work Report** issued at the National People's Congress: **China scrapped its GDP growth target for 2020**; the key priority this year will be on supporting jobs; and the fiscal deficit target rose to RMB 3.76 trillion (3.6% of GDP). Observers noted that stimulus announcements from the National People's Congress largely fell short of market expectations.
- **The U.S. State Department concluded that Hong Kong is no longer autonomous from mainland China**, as defined by U.S. law, which could lead to the U.S. changing or removing special privileges granted to Hong Kong. **This came after Chinese lawmakers began to debate a resolution that would authorize Beijing to write sweeping new national security legislation for Hong Kong**. China's legislative body approved the resolution on May 28, but it could take months to sort out the details related to laws about subversion, secession, terrorism, and foreign interference, according to Bloomberg. In the event the U.S. decides to revoke Hong Kong's special treatment under U.S. law, we think **the city could lose access to sensitive U.S. technology and face an increased threat of U.S. tariffs**. The short-term economic damage would likely be manageable, in our view, but it would accelerate the erosion of Hong Kong's status as an international business center.



MARKET SCORECARD

Data as of May 28, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,029.73	4.0%	-6.2%	8.1%	11.3%
Dow Industrials (DJIA)	25,400.64	4.3%	-11.0%	0.2%	2.6%
NASDAQ	9,368.99	5.4%	4.4%	23.2%	26.0%
Russell 2000	1,400.67	6.9%	-16.1%	-6.9%	-13.9%
S&P/TSX Comp	15,262.73	3.3%	-10.6%	-6.3%	-4.7%
FTSE All-Share	3,437.30	5.4%	-18.1%	-13.6%	-19.2%
STOXX Europe 600	355.47	4.5%	-14.5%	-5.4%	-8.8%
EURO STOXX 50	3,094.47	5.7%	-17.4%	-7.6%	-11.1%
Hang Seng	23,132.76	-6.1%	-17.9%	-15.5%	-24.9%
Shanghai Comp	2,846.22	-0.5%	-6.7%	-2.2%	-9.2%
Nikkei 225	21,916.31	8.5%	-7.4%	3.1%	-2.5%
India Sensex	32,200.59	-4.5%	-21.9%	-19.0%	-8.4%
Singapore Straits Times	2,515.24	-4.2%	-22.0%	-20.5%	-28.5%
Brazil Ibovespa	86,949.10	8.0%	-24.8%	-9.8%	15.4%
Mexican Bolsa IPC	36,508.14	0.1%	-16.2%	-13.5%	-18.6%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,718.55	1.9%	13.3%	34.3%	32.3%
Silver (spot \$/oz)	17.37	16.1%	-2.7%	21.0%	5.5%
Copper (\$/metric ton)	5,226.75	1.3%	-15.0%	-12.0%	-23.9%
Oil (WTI spot/bbl)	33.71	78.9%	-44.8%	-43.0%	-50.4%
Oil (Brent spot/bbl)	35.07	38.8%	-46.9%	-50.0%	-53.4%
Natural Gas (\$/mmBtu)	1.83	-6.3%	-16.6%	-29.3%	-37.9%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.697%	5.7	-122.1	-156.9	-223.5
Canada 10-Yr	0.563%	1.6	-113.9	-101.3	-174.1
U.K. 10-Yr	0.210%	-2.1	-61.2	-70.7	-111.1
Germany 10-Yr	-0.419%	16.7	-23.4	-25.8	-76.3
Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	1.39%	0.2%	5.2%	9.9%	16.8%
U.S. Invest Grade Corp	2.46%	1.1%	2.5%	10.2%	18.2%
U.S. High Yield Corp	7.07%	3.9%	-5.2%	0.3%	6.4%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	98.4730	-0.5%	2.2%	0.5%	4.3%
CAD/USD	0.7260	1.2%	-5.7%	-2.0%	-5.7%
USD/CAD	1.3774	-1.2%	6.0%	2.1%	6.0%
EUR/USD	1.1075	1.1%	-1.2%	-0.8%	-4.7%
GBP/USD	1.2317	-2.2%	-7.1%	-2.7%	-7.5%
AUD/USD	0.6637	1.9%	-5.5%	-4.1%	-12.0%
USD/JPY	107.6200	0.4%	-0.9%	-1.6%	-1.6%
EUR/JPY	119.1900	1.5%	-2.1%	-2.4%	-6.3%
EUR/GBP	0.8991	3.4%	6.3%	1.9%	3.0%
EUR/CHF	1.0679	1.0%	-1.6%	-5.0%	-7.6%
USD/SGD	1.4176	0.5%	5.3%	2.8%	5.6%
USD/CNY	7.1455	1.2%	2.6%	3.4%	11.7%
USD/MXN	22.2070	-8.1%	17.3%	15.7%	13.3%
USD/BRL	5.3879	-1.8%	33.7%	42.6%	44.3%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 9:35 pm GMT 5/28/20.

Examples of how to interpret currency data: CAD/USD 0.72 means 1 Canadian dollar will buy 0.72 U.S. dollar. CAD/USD -5.7% return means the Canadian dollar fell 5.7% vs. the U.S. dollar year to date. USD/JPY 107.62 means 1 U.S. dollar will buy 107.62 yen. USD/JPY -0.9% return means the U.S. dollar fell 0.9% vs. the yen year to date.

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